



DEAN F. ANDAL  
MEMBER, STATE BOARD OF EQUALIZATION

March 21, 2001

The Honorable Timothy B. Gage  
Director of Finance  
Department of Finance  
State Capitol, Room 1145  
Sacramento, CA 95814

Dear Tim:

I am writing to you in response to a memorandum sent to the Department of Finance (DOF) from Titus S. Toyama of the Franchise Tax Board entitled *Proposed Protest Regulations Questions*. The February 21, 2001 memo and attachments purport to answer questions contained in the December 21, 2000 DOF memo to the Franchise Tax Board (FTB). I have been informed that the Board Members were never given the opportunity to review Mr. Toyama's memo and accompanying attachments before they were sent to Department of Finance. Consequently, there are omissions and inaccuracies in the documents submitted by Mr. Toyama that must be addressed.

The first question by DOF was: *Have the number of protests increased or decreased since FTB Notice 99-1?*

The memo asserts an 8% increase in the number of protests filed. First, it should be stressed that the 8% increase represents only 11 cases. Out of the approximately 2,000 NPAs issued by the Multi-State Audit Bureau annually this is hardly a noticeable increase. Furthermore, the memo fails to provide the numbers of docketed protests *prior* to 1998. One year is not an adequate comparison.

The second part of DOF's question is, *"What does this suggest about the impact of speeding up protests from 33 to 24 months?"*

The honest answer is that it is too premature to tell. Without looking at a larger historical time period we have no way of knowing whether an 8% increase is statistically significant. Even if one were to accept the memo's unstated proposition that more taxpayers are entering protests because it is perceived as more taxpayer friendly<sup>1</sup>, in light of the 33-month completion goal found in FTB Notice 99-1, what does that prove? It is the outcome of the protests that impacts the State of California's budget, not the fact that 11 more protests have been filed. In truth, FTB will not be able to fully assess the impact of shortening the protest period until a representative sampling of cases that entered protest after FTB Notice 99-1 have been fully adjudicated through protest, appeals and the courts –something that will not occur for at least three more years.

Unfortunately, rather than be forthright about this and state that the FTB is uncertain of the impact, the memo goes on for two paragraphs attacking the Board of Equalization and discussing a supposed "loss of revenue" resulting from a "redirection of audit resources." There was no attempt to present both sides of the debate on whether to expedite the protest process. Moreover, the entire line of analysis was not responsive to the question asked. However, since FTB staff members have taken it upon themselves to raise these issues, I will respond.

Regarding the Board of Equalization, the memo states:

...there have been some recent instances where the SBE did not sustain FTB even though the factual record remained incomplete and the FTB argued that the taxpayer had failed to meet its burden of proof. (Appeal of Allied-Signal; Appeal of Fuji Bank; Appeals of Pentel Pens and Yamaha.)

This statement is utterly false. I bring to your attention the attached opinion of Timothy W. Boyer, Chief Counsel of the Board of Equalization. Rather than repeat Mr. Boyer's memo, I will only point out that each appeal listed above entered FTB's docketed protest prior to the publication of FTB Notice

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<sup>1</sup> The memo attempts to have it both ways on this point when it asserts in one sentence, "one impact of the 33-month regimen is that many taxpayers are having difficulty meeting the suggested time frames for producing evidence" and then three sentences later states "tightened time constraints at the protest level becomes an opportunity for the taxpayer to game the income tax protest and appeal systems to the state's disadvantage."

99-1 and hence, was unaffected by the 33-month time period. In fact, *Appeal of Allied Signal* was in audit and protest for more than 12 years! How many more years in protest does FTB staff believe would have been required for the State to have prevailed in that case?

*Appeal of Fuji Bank* was never in protest, but rather came to the Board of Equalization (BOE) on a deemed denial of a claim for refund. Hence, FTB's problem in that case is with the statute requiring them to act in six months on a claim for refund and not with the 33 months allowed in protest under FTB Notice 99-1.

The next paragraph offers more inaccuracies. The memo states:

The additional factual development needed at the audit level to replace the factual development loss resulting from the proposed regulation can only be accomplished through the re-direction of audit resources from pre-existing audit programs, if it is assumed that no new auditors are hired to improve the factual development at the audit stage. If such re-direction is necessary, staff estimates **revenue loss of approximately \$60 million per year**, resulting from loss of revenue from other audit programs that will be discontinued or curtailed. (Emphasis added.)

In 2000, FTB had 70 cases enter docketed protest with a total value of \$130 million in controversy. According to staff the State traditionally retains approximately 50% of assessments protested which includes losses at the BOE and in the courts. Hence, the memo would have you believe that state would have to spend \$60 million of audit time to defend \$65 million in assessments. To illustrate the absurdity of this statement, FTB's sustain ratio would have to drop below 4% after the protest hearing officer, BOE and the courts adjudicated the cases before it would be economically viable to spend an additional \$60 million in audit resources. Hence, you can understand why the Board rejected staff's request to spend \$60 million in audit resources to defend \$65 million in assessments.

But make no mistake about it, there is no evidence that these regulations will result in any reduction in the FTB's revenue collections. On the contrary, the protest regulations will increase the percentage of assessments sustained

by the audit branch by eliminating delay tactics, reducing procedural disputes, and forcing taxpayers to pay the assessment sooner.

The importance of forcing taxpayers to pay sooner cannot be understated. FTB's own settlement program reveals that FTB retains a significantly greater percentage of disputed taxes when the taxes in dispute have already been paid by the taxpayers. This fact is illustrated by FTB's settlement program, which in the year 2000 retained 65.2% of all unpaid taxes but 76.62% of all claims for refunds. For a more detailed list of reasons as to why the protest regulations will increase FTB's sustain ratio, please see my attached letter to Governor Davis dated December 27, 2000.

The other question by DOF that the memo purports to answer is "*What time constraints do large states like New York and Illinois place on protests?*"

Instead of simply providing a list of time frames the memo goes on for three pages concluding:

In this way, New York and Illinois acknowledge that both [expedited protest and fully developed factual records] are vital to a fair resolution of a tax dispute. In contrast, the proposed California protest regulation does not strike a similar balance, in that its practical effect may well be to accomplish the expeditious process of protests at the expense of full factual development.

The problem with this conclusion is that because further factual development is allowed at BOE and in court, it is unnecessary to hold protests indefinitely to develop a full factual record. Furthermore, since evidence is admissible at the BOE and in court, no matter how long FTB keeps a case in protest, taxpayers will always be able to claim they have discovered "new" evidence.

This, of course, raises the question of how much weight this new evidence should be given. In answering this question, one should first note that the burden of proof is always on the taxpayer in California. The notion that a large corporation would prevail at the BOE or in court by surprising the FTB with a last-minute deluge of evidence presupposes remarkable ignorance of

the rules of evidence as well as of the rules governing civil and administrative procedure.

Given the factual nature of multi-state audits, which in many instances consume more than 3,000 audit hours over several years, the BOE would look very skeptically at "new" evidence presented by the taxpayers. The BOE has stated this proposition numerous times, but perhaps most eloquently in 1996, in *Appeal of Beneficial California, Inc.* The opinion states in relevant part:

While "sandbagging" is not a term to be used lightly, it is nevertheless an apt description of what appears to have transpired in this appeal. Because of its failure to properly apprise respondent of these issues, there has been no opportunity to develop the facts necessary for either respondent or this board to evaluate these issues. Appellant did not raise the issues of distortion and factual unity in its refund claims and it may not do so now. (96-SBE-001)

The Board unanimously sustained the Franchise Tax Board.

Like the courts, the BOE appeals unit is staffed with attorneys (many of whom are former FTB attorneys, including Chief Counsel Boyer) not auditors. When audit issues arise, the Board will typically send the case back to FTB to examine any new evidence presented at the hearing. Moreover, no taxpayer wants to be labeled "uncooperative" by the FTB at the BOE or in court. A taxpayer has every incentive to answer all questions asked during audit and protest. In fact, the proposed regulations state that taxpayers have a duty to respond to FTB information requests and that a negative inference will be drawn if taxpayers fail to provide such information.

The memo makes extensive use of the word "hard-cap." Unfortunately, nowhere does it mention that the regulations provide for extension of the 24-month time frame at the discretion of the Chief Counsel and the taxpayer. Nor does the memo bother to mention that the time frame may be tolled for re-audit, settlement and other enumerated situations.

In comparing California with New York and Illinois, the memo states:

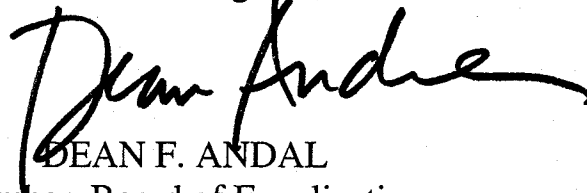
...at protest level in these states an urgency in the activity of the parties, an incentive and a requirement to fully develop the record at the protest level—and an inherent expeditiousness—all of which are lacking in California's protest procedures either as they currently exist or as they might be revised under the proposed regulation.

I would only add that it is the very lack of "inherent expeditiousness" in the California protest system that make time limits essential in California.

On a final note, I would like to voice my extreme displeasure that staff would present to DOF such one-sided views. This is especially inappropriate since Members and their staff spent countless hours reading written submissions by the public, working with FTB staff, attending public symposiums, and discussing the regulations in public FTB meetings.

In conclusion, I would urge you to take the actions necessary to see to it that these well reasoned protest regulations are adopted and the will of the FTB Board is not thwarted.

With best regards,

A handwritten signature in black ink, appearing to read "Dean Andale", written over the printed name.

DEAN F. ANDAL  
Member, Board of Equalization

DFA:js

Attachments

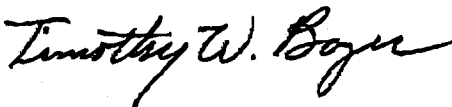
cc: Hon. Kathleen Connell  
Hon. Claude Parrish  
Ms. Annette Porini  
Mr. Larry Kreig  
Mr. Gerald H. Goldberg

# Memorandum

To : Honorable Dean Andal  
Board Member-2<sup>nd</sup> District

Date: March 21, 2001

From : Timothy W. Boyer  
Chief Counsel



Subject : FTB Appeals

Here is Staff's response to the questions asked in the March 15, 2001, memorandum. If you have any further questions, please do not hesitate to contact me or Selvi Stanislaus at (916) 324-2579.

## Question 1

Does Staff agree with the following sentence?

The SBE did not sustain FTB even though the factual record remained incomplete and the FTB argued that the taxpayer had failed to meet its burden of proof in: Appeal of Allied-Signal; Appeal of Fuji Bank; Appeal of Pentel Pens; and Appeal of Yamaha Corp.

If staff disagrees, please explain the Board's rulings in each of the above mentioned cases.

## Response:

Staff disagrees with the statement that BOE did not sustain FTB even though the factual record remained incomplete and FTB argued the taxpayer had failed to meet its burden of proof. A brief discussion of the issues in each case and the basis for the BOE's decision substantiate this conclusion.

### Appeal of AlliedSignal, Inc. (Allied)

In this case, the BOE considered the issue of whether Allied, was engaged in a single unitary business with its wholly owned subsidiary, Union Texas Petroleum (UTP). Contrary to Allied's California franchise tax returns, FTB determined Allied and UTP to be unitary. Initially, the BOE noted the acrimonious and lengthy nature of the audit and protest process, which extended approximately 12 years (and would have been longer if Allied did not come to the BOE on a deemed denial of a claim for refund) before reaching BOE. Actions by both parties contributed to this occurrence, and the BOE cautioned both parties against similar future actions.

In its decision, after citing the undisputed, governing case law, the BOE observed that a unitary determination depends upon the facts of each case and that each party presented

strong facts in support of their respective positions. Allied, a multidivisional conglomerate headquartered in New Jersey, manufactures a variety of products in this country and abroad. Originally, a chemical company, Allied expanded into numerous other business areas, which can be grouped into five industry sectors one of which is oil and gas. UTP, headquartered in Texas, served as Allied's oil and gas industry sector. Following its acquisition by Allied in 1962, UTP flourished and expanded globally.

In its decision, the BOE noted the dearth of BOE precedent and California case law combining such diverse business interests as at issue, namely, oil and gas, chemical, automotive, aerospace, and industry and technology. In fact, the BOE noted and agreed with the statement by the United States Supreme Court in Container Corp. v. Franchise Tax Board (1983) 463 U.S. 159, reh'g. den., 464 U.S. 909, that businesses sharing the same general product line are more amenable to a unitary finding because of the likely resulting economies of scale and sharing of expertise. In reaching its conclusion, the BOE relied heavily on the reasoning found in Tenneco West, Inc. v. Franchise Tax Board (1991) 234 Cal.App.3d 1510, in which the California Supreme Court determined oil and gas operations were not unitary with other types of operations, primarily manufacturing operations.

Pursuant to the applicable case law, the BOE's inquiry focused on two of the three unities identified in Butler Bros. v. McCollgan (1941) 17 Cal.2d 664, aff'd. (1942) 315 U.S. 501, namely, the unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions, and the unity of use in a centralized executive force and general system of operation. The BOE considered and discounted FTB's various arguments. The BOE found the testimony and declarations offered by witnesses for Allied substantiated that UTP's business was completely different from Allied's and that UTP operated autonomously. After reviewing the voluminous evidence, the BOE found that, although some intercompany product flow occurred, it was not sufficient to support a unitary finding. The BOE further determined that the companies did not share numerous common directors and/or employees. In fact, the BOE thought it impossible to share expertise of any value between such diverse businesses. FTB's contentions that Allied's operations contributed to, and were interdependent with, the operations of UTP were addressed, and the factors argued by FTB discounted. In addition, the BOE found numerous other factors supporting a conclusion that Allied and UTP were not unitary. For instance, the BOE found that Allied and UTP did not purchase inventory for each other, did not utilize a common sales force, did not market products under a common name, did not engage in common marketing, did not use common transportation facilities, did not share common physical facilities, did not engage in common research and development, and did not employ any common processes or patents. The BOE did find some factors in support of a unitary result, but found these to be minor and not determinative of the result. The BOE, therefore, concluded UTP engaged in distinct oil and gas operations, not a part of Allied's unitary manufacturing business.

#### **Appeal of Fuji Bank, Limited & Subsidiaries**

In this appeal, the BOE considered several issues, namely, whether the appeal should be dismissed due to Fuji's failure to exhaust its administrative remedies and whether gross proceeds or net proceeds from securities transactions conducted by subsidiaries of Fuji



should be included in the sales factor denominator. The letter decision issued by the BOE indicates the BOE concluded Fuji proved it was entitled to include gross proceeds from the securities transactions in the sales factor denominator. The BOE also noted significant concerns regarding the procedural aspect of the appeal.

During the briefing process, the FTB complained that, despite several information requests, Fuji failed to provide sufficient evidence to substantiate its position and to allow FTB to adequately develop the factual record for the Board. Fuji, however, responded that FTB had four years in audit and six months during the refund phase to develop the record. Further, Fuji contended and the BOE agreed that it substantially complied with FTB's requests. In its decision, the BOE stated it would dismiss a case for failure to exhaust administrative remedies if a taxpayer shows substantial disregard for the administrative process leading to an appeal and FTB diligently represented the State's interests. The BOE indicated, however, that it did not find either factor satisfied in the case. Although the BOE recognized Fuji failed to cooperate in good faith with FTB's requests, the BOE also found FTB failed to make timely and relevant requests for information. Therefore, the BOE concluded both parties assumed some responsibility for the status of the case before the Board.

The appeal primarily involved two of Fuji's subsidiaries. At the hearing, Fuji withdrew its appeal with respect to one of the subsidiaries, leading to a finding in favor of FTB with respect to that entity. With respect to the remaining subsidiary, Fuji Securities, Inc., the BOE concluded that based on the evidence presented, gross proceeds from its securities transactions should be included in the sales factor denominator. Fuji originally filed its California returns as a bank/financial institution and utilized the special apportionment formula for that industry, which requires inclusion of net proceeds rather than gross proceeds from the sales of securities in the sales factor. Upon audit, FTB determined that at least three of the corporations in the Fuji group should be treated as general corporations. Fuji paid the amounts determined by FTB and filed claims for refund. Fuji argued that the standard apportionment formula should apply, rather than the special formula for banks/financial institutions. The conflicts between the parties escalated during the protest process, leading to the BOE's procedural concerns regarding this matter.

The parties argued two BOE precedents with respect to this issue, namely, Appeals of Pacific Telephone and Telegraph, decided May 4, 1978 (Pacific Telephone), and Appeal of Merrill Lynch, Pierce, Fenner and Smith, Inc. (89-SBE-017), decided June 2, 1989 (Merrill Lynch). Pacific Telephone includes the sales proceeds in the sales factor at net because the securities transactions are incidental to the taxpayer's business and result in a distortion of the taxpayer's business activities in state, while Merrill Lynch includes the sales proceeds in the sales factor at gross because the securities transactions are an integral part of the taxpayer's business and do not result in a distortion of the taxpayer's business activities in state. The parties offered facts in support their respective positions. The hearing summary provided by staff suggested the BOE should strike down any formula that assigns to California a percentage of income which is clearly "out of all appropriate proportion to the business transacted" in California. The BOE found Fuji's securities transactions conducted by its subsidiary, Fuji Securities, Inc., more in the nature of those described in Merrill Lynch, than

those described in Pacific Telephone, and thus included the gross sales proceeds in the sales factor.

**Appeals of Yamaha Motor Corp., USA, and Pentel of America, Ltd.**

As an introductory note, the Appeal of Yamaha Motor Corp. (Yamaha) and the Appeal of Pentel of America, Ltd. (Pentel) were decided on the same day. The primary issue and factual circumstances in Pentel were apparently substantially similar to those in Yamaha, and thus the decision in Pentel adopts the decision reached in Yamaha. Upon review of the summary decision in Pentel, no factual disputes are raised or discussed. At the outset of Yamaha, the opinion states that there is no dispute of the pertinent facts of the appeal. Thus, staff notes these decisions appear to turn on the BOE's interpretations of statutes, regulations, and case law, or the lack of guidance in those areas. An allegation that the factual record of either case remained incomplete does not appear appropriate.

In these cases, the BOE considered whether the taxpayer should recognize any portion of profits from intercompany inventory sales in its water's edge combined report if those profits had been properly eliminated from its combined report in the year prior to making the water's edge election. Yamaha is a wholly owned subsidiary of Yamaha Motor Company, Ltd. (YMC), a Japanese corporation. Yamaha owned three domestic subsidiaries, which formed its unitary group. YMC sold a significant volume of inventory to Yamaha, which remained in Yamaha's inventory at the end of the tax year (the 1989 income year). YMC, Yamaha, and the various other subsidiaries filed a worldwide combined report for California purposes for the 1989 income year. Citing Chase Brass & Copper Co., Inc. v. Franchise Tax Board (1977) 70 Cal.App.3d 457, 473, the BOE indicated that for tax purposes the unitary group properly eliminated YMC's inventory profit and reduced Yamaha's ending inventory by the same amount on the basis that a transaction between members of the same unitary group does not result in economic gain to that group. For accounting purposes, however, YMC failed to apply the elimination method to its accounting records, contrary to the practice espoused by FTB.

The following year, income year 1990, Yamaha elected to report its California taxes on a water's edge basis. Thus, while YMC was still part of Yamaha's unitary group, it was not part of Yamaha's reporting group. In that year, Yamaha sold the YMC inventory to third parties, thereby realizing income from the sale. The parties agreed that Yamaha should recognize income at least equal to the difference between its cost basis and the sales price, the parties disagreed as to the treatment of the profit by YMC on the sale of the inventory to Yamaha. Since YMC was no longer a part of its reporting group, Yamaha did not report this gain in its 1990 income year California combined report. FTB argued Yamaha should report the gain as the difference between YMC's basis and Yamaha's sales price.

The Board concluded in favor of Yamaha. In considering the appeal, the BOE noted that the Revenue and Taxation Code, its regulations thereunder, or case law failed to address this issue. Further, the BOE found that FTB's guidance on the issue, as set forth in Publication 1061, was insufficient. Under these circumstances, the BOE relied on the California

Supreme Court's conclusion in Edison California Stores, Inc. v. McColgan (1947) 30 Cal.2d 472, 476, that ambiguities are to be resolved in favor of the taxpayer.

The BOE also concluded that FTB's reliance on its general rulemaking authority found in Revenue and Taxation Code section 19053, subdivision (a), its reliance on its own statements in Publication 1061, and its reliance on generally accepted accounting principles did not support a conclusion in its favor, given the absence of a definitive statute or regulation governing the issue at hand. In fact the BOE gave great weight to the lack of regulation in this area.

### Question 2

Were the issues adjudicated in the Appeal of Fuji Bank ever dealt with at FTB's Protest or did it come to the BOE on deemed denial of a claim for refund?

### Response:

No, the issues were not dealt at protest and Fuji came to the BOE on March 11, 1999, on a deemed denial of its claims for refund by FTB. As discussed above, Fuji's appeal to the BOE is the consequence of an FTB determination, during a four-year audit that Fuji were general corporations (and not financial corporations as Fuji had determined) and, therefore, not subject to the special apportionment rules applicable to banks and financial corporations. Upon reaching this conclusion, the FTB made an adjustment to the apportionment formula, specially the property factor, which increased Fuji's tax liability; however, it failed to adjust the receipt factor, which favors Fuji. Fuji made the appropriate adjustments to its receipt factor called for by the statute and filed the refund claims first with FTB and six months later with the BOE.

### Question 3

How many years were the tax years at issue in the Appeal of AlliedSignal under audit and in protest.

### Response:

12 years.

TWB:jd  
Andal:ss

cc: Honorable Claude Parrish  
Honorable John Chiang  
Honorable Johan Klehs  
Honorable Dean Andal  
Honorable Kathleen Connell  
Mr. James E. Speed